Australian Government

Multiple entry consolidated groups

Treasury consultation on possible options identified in the MEC group tripartite review

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ABOUT THIS PAPER

The purpose of this paper is to seek views on possible options to improve the taxation of Multiple Entry Consolidated (MEC) groups.

CONSULTATION DEADLINE

Submissions in response to this paper are sought by 20 April 2015.

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Contents

1. INTRODUCTION

1. Following the recommendations of the Multiple Entry Consolidated (MEC) group tripartite review, in the 2014-15 Budget the Government asked the Treasury to consult on a possible amendment to improve the integrity of the tax system by extending a modified form of the unrealised loss rules to MEC groups.

2. The Government also asked Treasury to consult on selected announced but unenacted measures that the Government had *referred* to the tripartite review.

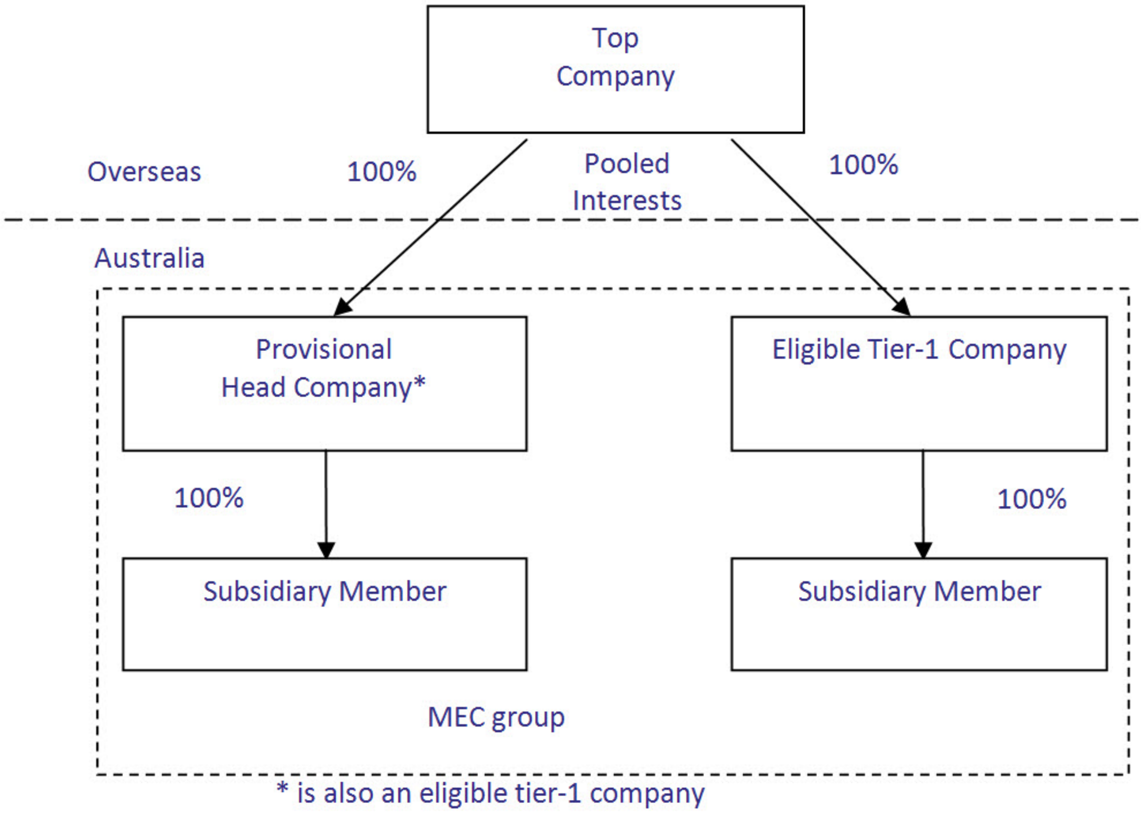
3. A full copy of the tripartite review is available from the *Treasury website*.

4. The purpose of this consultation paper is to seek stakeholders' views on the relevant proposals.

2. THE PROBLEM AS IDENTIFIED IN THE MEC GROUP REVIEW

5. MEC groups are corporate groups, treated as a single taxpayer; consisting of Australian-resident entities that share a common ultimate foreign owner (Top Company) (see Diagram 1). The entities that represent the first entry points of ownership by the Top Company into Australia are referred to as Eligible Tier-1 companies (ET-1s).

Diagram 1: Multiple Entry Consolidated Groups



6. When a subsidiary joins an ordinary consolidated group, it is subject to the tax cost setting rules. Upon joining, these rules establish the tax costs that are given to the assets of the subsidiary; that is, the joining entity's assets have their tax costs reset.

7. In contrast, a MEC group is able to choose between retaining the cost base of a joining entity's assets (by bringing an entity holding the assets in at the ET-1 level) or resetting the cost base of a joining entity's assets (by bringing the entity holding the assets in at the subsidiary level).

8. This choice can result in unintended tax outcomes as compared to tax consolidated groups if MEC groups bring in entities at the ET-1 level and the entity's assets have a lower market values as compared to their current cost bases. By retaining the higher cost bases of these assets, MEC groups can reduce future capital gains or enhance depreciation deductions, depending on the character of the assets.

9. The unintended tax outcome could be reduced by applying a modified version of the unrealised loss provisions (subdivision 165-CC of the *Income Tax Assessment Act 1997* (ITAA 1997)) to MEC groups.

3. POSSIBLE AMENDMENTS

10. Two approaches were considered by the tripartite review to address the identified problem. The first approach was to extend the application of section 715-70 of the ITAA 1997 (about creating a loss denial pool at formation in respect of a joining subsidiary member's assets that are in an unrealised loss position) to an ET-1 that joins a MEC group. The second approach was to apply a modified version of these unrealised loss provisions to the assets of ET-1s that join MEC groups.

11. While it is important to get the right policy outcome, the tripartite review recognised that some consideration should also be given to commercial and practical difficulties and compliance costs involved, and accordingly recommended the Government consult on the second approach.

12. The second approach that was proposed has compliance cost benefits because it better targets the unintended tax outcome by way of immediate adjustments that can impact on capital allowance deductions as well as gains and losses on subsequent disposal of loss assets. The compliance cost benefits are that:

- there is no requirement for the modified same business test to be applied; and
- the immediate reduction in the tax cost of the joining ET-1's loss assets at the joining time will mean that there is no need to track these assets on a going forward basis.

13. This possible amendment would better align the tax value of loss assets with their market value, and would therefore partially address the unintended tax outcome while limiting the compliance cost involved and distortions to commercial arrangements.

14. Under this approach, the unintended tax outcome would be limited through adjustments, at the joining time, to the tax cost base of those 'loss assets' owned by the joining entity. The proposed adjustment will effectively spread the total 'unrealised net loss' across the loss assets of the joining entity.

15. To reduce compliance costs, the proposed adjustment would only be necessary where the market value of the joining ET-1 is lower than the tax cost base of the assets it holds.

16. The unrealised net loss of the joining ET-1 would be calculated in accordance with the method for the existing loss denial pool rules in section 165-115E of the ITAA 1997. Consideration would also be given to including the compliance cost concessions in those rules which, for example, allow for the exclusion of assets acquired for less than $10,000 from the calculation.

17. The reason that the total unrealised **net** loss is spread (rather than the total unrealised **gross** loss) is that it would be unfair to spread the total unrealised gross loss without also recognising the tax cost base of the assets that have unrealised gains. This effectively allows the tax value of the whole asset pool of the joining entity to align with its market value at the joining time.

18. When the adjustments are triggered, the total unrealised net loss of the joining ET-1 (assessed at the joining time or an earlier time if there was a change in the majority beneficial ownership at an earlier time) would be apportioned to those assets that have unrealised losses (loss assets) to reduce their tax costs at the joining time.

19. Specifically, the tax cost of a loss asset of the joining ET-1 at the joining time would be reduced by a proportion of the ET-1's unrealised net loss as assessed at the time there was a change in the majority beneficial ownership. The loss asset's proportion of the unrealised net loss for this purpose is the amount that represents that loss asset's proportionate share of the total unrealised loss for all of the loss assets at the joining time (as shown in the formula below).

$$Adjusted\ Cost\ Base = A - \left[B \times \frac{C}{D}\right]$$

Where:

A is the existing tax cost base of the loss asset;

B is the total unrealised net loss of the joining ET-1 assessed at the time there was a change in the majority beneficial ownership

C is the unrealised loss of the loss asset

D is the sum of all unrealised losses of loss assets

20. The following tables set out three different scenarios on how the proposed rule would apply when an ET-1 joins a MEC group. In each scenario, it has been assumed that there has been no change in the market value and cost base of the joining ET-1's assets from the time there was a change in the majority ownership or control of the joining ET-1 (that is, the time the unrealised net loss was calculated) and the joining time.

Scenario A: Gross reduction in all market values — Joining ET-1 has an unrealised net loss

Assets	Existing Tax Cost Base	Market Value	Unrealised Gain(Loss)	Adjustment Triggered?	Adjusted Cost Base
Asset A	100	60	(40)	YES	60
Asset B	100	40	(60)		40
Asset C	100	20	(80)		20
Total	300	120	(180)		120
Comment: This is the simplest scenario to deal with, where there is an unrealised loss in respect of each asset.					

Scenario B: Net increase in market values (but reduction in some market values) — Joining ET-1 does not have an unrealised net loss

Assets	Existing Tax Cost Base	Market Value	Unrealised Gain (loss)	Adjustment Triggered?	Adjusted Cost Base
Asset A	100	300	200	NO	n/a
Asset B	100	40	(60)		n/a
Asset C	100	20	(80)		n/a
Total	300	360	60		n/a

Comment: Because the adjustment mechanism is only triggered if there is an overall unrealised net loss at the pre-joining time change in majority ownership or control of the ET-1, there would be no adjustment in this scenario even though there may be significant unrealised losses relating to some assets with more than a compensating increase in unrealised gains in respect of other assets. This would be the same outcome if the first approach (about extending section 715-70 to ET-1 companies) in paragraph 10 above were to be adopted.

Scenario C: Net decrease in market values (but increase in some market values) — Joining ET-1 has an unrealised net loss

Assets	Existing Tax Cost Base	Market Value	Unrealised Gain (loss)	Adjustment Triggered?	Adjusted Cost Base
Asset A	100	180	80	YES	100
Asset B	100	40	(60)		74
Asset C	100	20	(80)		66
Total	300	240	(60)		240

Comment: In this scenario, the adjustment apportions the total unrealised net loss ($60) to the loss assets (Asset B and Asset C) in accordance to their share of the total unrealised loss ($140) at the joining time when there was a change in the majority beneficial ownership.

After the adjustment, the tax value of the ‘loss assets’ (Asset B and C) would be higher than their market value and the tax value of the ‘gain asset’ (Asset A) would be lower than its market value. However, the overall effect is that the tax value of the entire asset pool would be equal to its market value. This is because the reduction in tax value of the ‘loss assets’ takes account of the unrealised gain in respect of the ‘gain asset’.

Question 1:

We seek your views on the possible amendment, in particular with regard to:

- the merits of the amendment;
- the compliance cost implications;
- whether it would cause any significant impact to commercial arrangements; and
- whether the recommended approach would result in any significant anomalies.

4. Measures to clarify certain aspects of the consolidation regime relating to MEC groups

21. As part of its *announcement* on announced but unenacted tax measures, the Government on 14 December 2013 referred a small number of MEC group related measures to the MEC group review. These measures were originally *announced* by the former Assistant Treasurer on 11 May 2010, with a discussion paper released for a period of consultation.

22. The possible amendments aim to ensure that the consolidation regime operates as intended by clarifying that:

1) a provisional head company of a MEC group can enter into a tax sharing agreement with other members of the group;
2) Pay As You Go (PAYG) instalments paid by, a former provisional head company of a MEC group; and the former head company of a consolidated group where that head company is replaced by an interposed head company during an income year; are attributed to the group;
3) the joint and several liability rules apply where a consolidated group or MEC group that is subject to PAYG as a single entity (a mature group) is acquired by another consolidated group or MEC group that is not subject to PAYG as a single entity (a transitional group); and
4) various parts of the income tax law apply to MEC groups in the same way that they apply to consolidated groups.

23. The tripartite review considered that the first two issues should be legislated when time and resourcing allows with the third issue being consequential to the second, and the fourth issue to be considered in a broader 2015 review of consolidated groups.

24. The tripartite review also noted that some inconsistencies between MEC groups and ordinary consolidated groups relating to the fourth issue could be relatively straightforward to legislate and therefore should be considered when time and resourcing allows. For example, there was a modification to CGT event J1 when the consolidation rules were introduced but this modification did not apply to MEC groups, resulting in adverse outcomes for MEC groups. This issue was raised by the Board of Taxation in its *Post implementation review of certain aspects of the consolidation tax cost setting process* (Recommendation 7.4). The Board recommended that the income tax law be amended to rectify the inappropriate outcome in the context of a subsidiary (non ET-1) member of a MEC group leaving the group.

25. It is expected that all possible changes will have prospective application, except those that are related to Tax Sharing Agreements (TSAs). This is because taxpayers are likely to benefit from the certainty provided by a retrospective change to rules on TSAs.

Clarify that a provisional head company of a MEC group can enter into a tax sharing agreement with other members of the group

26. Where a head company does not pay a tax related liability by the date due and payable, Division 721 of the ITAA 1997 confirms that the subsidiary members of the group are jointly and severally liable, unless the tax law modifies that approach. The existence of a TSA that is recognised under Division 721 is the main mechanism for modifying the application of the joint and several liability rules.

27. Where a TSA is recognised by the ITAA 1997, limits on the amount of a tax related liability that will be collected from the individual subsidiary members apply. In that case, the Commissioner seeks to recover only the specified reasonable portion (contribution amount) from each member (TSA contributing member), in accordance with the TSA.

28. In addition, section 721-35 of the ITAA 1997 enables a TSA contributing member to leave a consolidated group clear of a group liability where the tax sharing agreement is valid and the leaving entity has paid their contribution amount to the head company before the leaving time.

Possible changes

29. One option would be to amend Division 721 to clarify that it applies to a provisional head company of a MEC group in the same way that it applies to a head company of a consolidated group. Therefore, a provisional head company of a MEC group will be able to enter into a TSA under Division 721 with other members of the group. This allows a TSA to be established in respect to tax-related liabilities that a provisional head company incurs as a provisional head company; for example PAYG instalments incurred in the course of the income year.

30. Another possible option would be to amend section 721-35 to allow a clear exit payment to be made before the head company's due time (that is, the time at which the tax related liability is due and payable). At present, section 721-35 requires the clear exit payment to be made prior to the leaving time of the exiting member. Changing this to the later date of the head company's due time will allow the exiting member to make a payment under section 721-35 towards the group liability after its departure from the group, so long as the payment is made before the head company's due time. This possible rule could extend to an exiting member that was the former provisional head company of the MEC group.

Clarify that PAYG instalments paid by a former provisional head company of a MEC group are attributed to that group

31. The single entity rule applies for the purpose of applying the PAYG instalment provisions in Part 2-10 of Schedule 1 to the *Taxation Administration Act 1953* (TAA) (section 45-710 of Schedule 1 to the TAA).

32. The table in subsection 45-910(2) of Schedule 1 to the TAA modifies Part 2-10 so that the provisions have effect in relation to MEC groups. Specifically:

- a reference to a consolidated group is taken to be a reference to a MEC group;
- a reference to the head company of a consolidated group is taken to be a reference to the provisional head company of a MEC group; and

- a reference to a subsidiary member of a consolidated group is taken to be a reference to a member (other than the provisional head company) of the MEC group.

33. Section 45-915 of Schedule 1 to the TAA explains how Subdivision 45-Q (about PAYG instalment payments) applies to MEC groups and provides that the provisional head company of the MEC group is liable to pay the PAYG instalments as they arise.

34. Under section 45-30 of Schedule 1 to the TAA, a taxpayer is entitled to a credit for PAYG instalment payments made in respect of an income year when an income tax assessment is made for the taxpayer.

35. Section 161 of the ITAA 1936 requires the head company of the MEC group to lodge the income tax return for the preceding income year. Section 166 of the ITAA 1936 requires the Commissioner to make an assessment of income and tax payable of any taxpayer, in this case the head company of the MEC group.

36. For a MEC group that was in existence for an entire income year, the entity that is the provisional head company of the MEC group at the end of the income year will become the head company of the MEC group for that income year. Therefore, for the purposes of section 45-30, the taxpayer that should be entitled to the credit for PAYG instalments paid during the MEC group's income year will be the head company of that group.

37. Similarly, sections 161 and 166 apply in relation to the head company of a consolidated group and it is that head company that is entitled, under section 45-30, to the credit for PAYG instalments paid during the income year.

Possible changes

38. The law could be amended so that, where there is a change to the head company of a consolidated group because a new head company is interposed between the old head company and its members (an interposed head company) or where there is a change in the provisional head company of a MEC group during an income year, credits arising from PAYG instalment payments made by the former head company or the former provisional head company in respect of the income year are credited to the group.

39. To achieve this, an amended section 45-30 could apply where:

- an interposed head company becomes the head company of the group or there is a change in the provisional head company of a MEC group, during an income year; and

- an amount of instalment payable by the former head company or the former provisional head company, or amount of credit claimed by it under sections 45-215 or 45-420 of Schedule 1 to the TAA, are taken into account in working out a credit entitlement of the new head company or new provisional head company.

40. In these circumstances, to the extent that the amount is taken into account by the new head company, it will not be taken into account in working out any credit entitlement of the former head company or the former provisional head company under section 45-30 for any year. The new head company may only take into account credit entitlements of the former head company or the former provisional head company that arose in its capacity as the head company or former provisional head company.

Ensure the joint and several liability rules apply where a mature PAYG consolidated group or MEC group is acquired by a PAYG transitional group

41. Subdivision 45-R of Schedule 1 to the TAA contains special rules that apply to members of a consolidated group after that group has come into existence but before the members are treated as a single entity for PAYG purposes (a PAYG transitional group). One of these special rules is that the single entity rule is disregarded for the purposes of determining the PAYG instalment, so that each subsidiary member must pay their own tax-related liability during the consolidation transitional year (section 45-855 of Schedule 1 to the TAA). Thus, the head company is not liable for the debts of the subsidiary members during the transitional year.

42. The single entity rule starts to apply for the purposes of determining the PAYG instalments the head company must pay during the income year from, broadly, the start of the instalment quarter during which the Commissioner gives the head company an initial head company instalment rate (a PAYG mature group).

43. The joint and several liability rules in Division 721 of the ITAA 1997 apply to the tax related liabilities of the head company of a consolidated group or the provisional head company of a MEC group. The tax related liabilities include a liability to pay quarterly PAYG instalments.

44. When a PAYG mature group is acquired by a PAYG transitional group, the PAYG mature group is treated, for PAYG purposes only, as a preserved group. The head company of the preserved group is then responsible for the preserved group's PAYG instalment liabilities until such time as the PAYG transitional group becomes a PAYG mature group.

45. While the PAYG mature group is treated as a preserved group for PAYG purposes when it is a member of the PAYG transitional group, it is no longer a consolidated group for the purposes of Division 721 as its head company is no longer eligible to be a head company. As a result concerns have been raised that the subsidiary members of the preserved group are not jointly and severally liable for any unpaid quarterly PAYG instalments of the head company of the preserved group.

Possible changes

46. The law could be amended to clarify that, if a PAYG mature consolidated group is acquired by a PAYG transitional group and it becomes a preserved group for PAYG instalment purposes the members of the preserved group will, subject to a TSA, be jointly and severally liable for the PAYG instalment liabilities of the preserved group.

Modification to CGT event J1 to avoid double counting of capital gain or loss on the rolled over asset when a subsidiary member leaves a MEC group

47. The tripartite review also notes that some inconsistencies between MEC groups and ordinary consolidated groups relating to the fourth issue can be relatively straightforward to legislate. For example, there was a modification to CGT event J1 when the consolidation rules were introduced, but this modification did not apply to MEC groups resulting in adverse outcomes for MEC groups.

48. This issue was raised by the Board of Taxation in its *Post implementation review of certain aspects of the consolidation tax cost setting process* (Recommendation 7.4). The Board recommends that the income tax law should be amended to rectify the inappropriate outcome in the context of a subsidiary (non-ET-1) member of a MEC group leaving the group.

49. The Board's report notes that when a subsidiary member that is not an ET-1, leaves a MEC group, the capital gain or loss on the disposal of the membership interests is calculated using the Division 711 exit tax cost setting rules that apply when an entity leaves a group.

50. CGT event J1 may also apply to include a capital gain or loss made on the rolled over asset. As noted above, CGT event J1 was modified when the consolidation rules were introduced such that it does not apply in respect of a subsidiary member in receipt of a rolled over asset which leaves a consolidated group. However, as only consolidated groups are referred to, the modification does not apply to MEC groups.

51. Consequently, where such a subsidiary member (that is not an ET-1 entity) leaves a MEC group, the capital gain or loss on the rolled over asset may be included in taxable income twice.

Possible changes

52. It is possible that the CGT event J1 could be amended to rectify the duplication of capital gains and capital losses made on the rolled over assets, when subsidiary (non ET-1) members in receipt of these rolled over assets exit a MEC group.

53. This is the same proposal as in Recommendation 7.4 of the Board of Taxation's 2013 *Post implementation review of certain aspects of the consolidation tax cost setting process*.

Question 2:

We seek your comments generally on the possible amendments, in particular:

- whether those possible changes would deliver compliance benefits to businesses, that warrants them being accorded priority on the legislation program;
- whether they would deliver the correct tax and commercial outcomes; and
- whether they would cause any significant concerns.